## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 231

**[Release No. 33–7190; International Series No. 821; File No. S7–20–95]**

## Problematic Practices Under Regulation S

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Interpretive Release; Request for Comments.

**SUMMARY:** The Commission is publishing its views concerning problematic practices under Regulation S and is requesting comment as to whether Regulation S should be amended to limit its vulnerability to abuse. The Commission will study the comments received in response to this release and will determine whether rulemaking or other action is necessary or appropriate.

**DATES:** This interpretation is effective July 10, 1995. Comments should be received on or before September 8, 1995.

**ADDRESSES:** Comment letters should refer to File number S7–20–95 and should be submitted in triplicate to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. The Commission will make all comments available for public inspection and copying in its Public Reference Room at the same address.

**FOR FURTHER INFORMATION CONTACT:** Paul Dudek or Annemarie Tierney, (202) 942–2990, Office of International Corporate Finance, Division of Corporation Finance, U.S. Securities and Exchange Commission, Washington, D.C. 20549.

**SUPPLEMENTARY INFORMATION:** The Commission is stating its views with respect to certain problematic practices in connection with offers and sales under Regulation S,[1] the safe harbor under the Securities Act of 1933 (the ''Securities Act'')[2] for offshore offerings or resales, and is requesting comment as to whether specific amendments to Regulation S are necessary to curtail Regulation S abuses.

In addition, in a companion release,[3] the Commission is publishing for comment rule revisions that would eliminate certain impediments to registered offerings of securities under the Securities Act by streamlining requirements with respect to financial statements of significant acquisitions. Also in the companion release, rule revisions are proposed that would require registrants to report on a quarterly basis recent sales of equity securities that have not been registered under the Securities Act.

### I. Introduction

The Commission adopted Regulation S in April 1990 in order to clarify the extraterritorial application of the registration requirements of the Securities Act.[4] Since adoption, a number of problematic practices have developed involving unregistered sales of equity securities of domestic reporting companies purportedly in reliance upon Regulation S. In this release, the Commission states its views concerning these problematic practices and is requesting comment as to whether Regulation S also should be amended to impose additional restrictions on its use to impede attempts to use the Regulation to evade the registration requirements of the Securities Act.

Commenters have suggested that companies may be compelled to sell securities offshore, rather than in registered transactions, because of the registration disclosure requirements relating to significant acquisitions. In a companion release, the Commission is proposing to streamline these requirements to reduce regulatory impediments to the use of registered offerings. Also, in response to commenters' suggestions that investors need information about private or offshore placements of equity securities that is not currently required to be disclosed, the Commission is proposing to require quarterly reporting of unregistered equity offerings. Commenters have suggested this public reporting may also have the ancillary benefit of deterring abuses of Regulation S. The Commission in this release is soliciting comment as to other regulatory burdens that may cause issuers to resort to offshore offerings rather than registered public offerings.

### II. Interpretive Guidance on Regulation S Practices

Regulation S contains a general statement providing that Section 5 of the Securities Act[5] shall be deemed not to apply to offers or sales of securities that occur outside the United States[6] and two non-exclusive safe harbors.[7] However, neither of the safe harbors nor the general statement is available for a transaction or series of transactions that, although in technical compliance with the regulation, is part of a plan or scheme to evade the registration requirements of the Securities Act.[8]

Preliminary Note 2 to Regulation S states that ''* * * Regulation S is not available with respect to any transaction or series of transactions that, although in technical compliance with these rules, is part of a plan or scheme to evade the registration provisions of the Act. In such cases, registration under the Act is required.'' This release pertains only to violations of Section 5 in connection with Regulation S offerings and does not address issues dealing with the antifraud provisions of the federal securities laws.

The safe harbors provide specific guidance to issuers and other market participants as to conditions under which a transaction will be deemed to occur outside the United States. One safe harbor applies to offers and sales by issuers, underwriters and other persons involved in the distribution process pursuant to contract (defined as ''distributors'') and any person acting on behalf of the foregoing (the ''issuer safe harbor'').[9] The other safe harbor applies to resales by persons other than the issuer, distributors, their respective affiliates (except certain officers and directors) and persons acting on behalf of the foregoing (the ''resale safe harbor'').[10] An offer and sale of securities that satisfies all conditions of the applicable safe harbor is deemed to be outside the United States and thus is not subject to the registration requirements of Section 5, *provided that* it is not part of a plan or scheme to evade registration.[11]

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[1] 17 CFR 230.901–904.

[2] 15 U.S.C. 77a *et seq.*

[3] Securities Act Release No. 7189.

[4] Securities Act Release No. 6863 (April 24, 1990) [55 FR 18306] (the ''Adopting Release'').

[5] 15 U.S.C. 77(e).

[6] *See* Rule 901. Whether a transaction occurs outside the United States within the meaning of Rule 901 is a question of the facts and circumstances of the transaction. See the Adopting Release at footnote 18 and accompanying text.

[7] *See* Rules 903 and 904.

[8] *See* Preliminary Note 2 to Regulation S.

[9] *See* Rule 903. The issuer safe harbor distinguishes three categories of securities offerings, based upon factors such as the nationality and reporting status of the issuer and the degree of U.S. market interest in the issuer's securities. Under the issuer safe harbor, varying procedural safeguards are imposed with the intent of having the securities offered come to rest offshore.

[10] *See* Rule 904.

[11] Section 5 of the Securities Act prohibits any person, directly or indirectly, from using instrumentalities of interstate commerce or the mails to offer or sell a security unless a registration statement has been filed or is in effect as to such security. Exemptions from the registration provisions are set forth in Sections 3 and 4 of the statute, and the related rules promulgated under the Securities Act. A person who offers or sells a security in reliance upon an exemption from the registration requirements of Section 5 has the

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Since the adoption of Regulation S, it has come to the Commission's attention that some market participants are conducting placements of securities purportedly offshore under Regulation S under circumstances that indicate that such securities are in essence being placed offshore temporarily to evade registration requirements with the result that the incidence of ownership of the securities never leaves the U.S. market, or that a substantial portion of the economic risk relating thereto is left in or is returned to the U.S. market during the restricted period, or that the transaction is such that there was no reasonable expectation that the securities could be viewed as actually coming to rest abroad. These transactions are the types of activities that run afoul of Preliminary Note 2, would not be covered by the safe harbors and would be found not to be an offer and sale outside the United States for purposes of the general statement under Rule 901.[12]

The practices described below generally have involved equity securities of U.S. companies whose securities are traded principally, and typically solely, in the United States.

There have been a variety of schemes involving parking securities with offshore affiliates of the issuer or a distributor. In these transactions, Regulation S is claimed as the basis to sell securities to offshore shell entities formed by the issuer or a distributor (or, in some cases, persons closely associated with the issuer or distributor) to purchase the securities. The entities hold the securities for the restricted period; at the end of that period, proceeds from the U.S. sale make their way, directly or indirectly, to the issuer or distributor. These transactions do not qualify for either the Regulation S safe harbor or the Rule 901 general statement since they are nothing more than sham offshore transactions structured to evade the Securities Act registration requirements.

Troubling issues also have arisen under the resale safe harbor provisions of Rule 904. Rule 904 cannot be used for the purpose of ''washing off'' resale restrictions, such as the holding period requirement for restricted securities in Rule 144.[13] Likewise, the restricted status of securities is not affected by a prearranged transaction by or on behalf of the seller conducted offshore. If a person with restricted securities sold the securities in an offshore transaction and replaced them with a repurchase of fungible unrestricted securities, the replacement securities would be subject to the same restrictions as those replaced.

As noted, the Commission has become aware of a number of instances where the total mix of factors raises the concerns described above. These factors, any one of which may serve to indicate that the economic or investment risk never shifted to the offshore purchaser, and that the securities—as a matter of substance as opposed to form—never left the United States or remained offshore for less than the restricted period, have included the use of: (i) non-recourse promissory notes (notes where the purchaser never is at risk in connection with the purchase of the securities) for all or almost all of the purchase price, where the expectation of repayment stems from the resale of the securities into the U.S. market, (ii) recourse notes where the entity providing the notes is unknown to the seller of the securities or the entity has no, or minimal, assets where, again, the expectation of repayment stems from the resale of the securities into the U.S. market, (iii) fees paid to the purchaser of the securities to hold the securities for the restricted period, whether paid directly or as more frequently seems to be done through significant[14] discounts to the U.S. market price for the issuer's stock, where the fees or discounts are such to indicate that the transaction was intended to create a parking scheme or other scheme where the securities were merely being held offshore to evade the registration requirements, and (iv) short selling and other hedging transactions such as option writing, equity swaps or other types of derivative transactions,[15] where purchasers transfer the benefits and burdens of ownership back to the United States market during the restricted period.[16]

In these cases it appears the transaction is nothing more than a delayed sale by the seller in the United States, with the purported offshore purchaser serving as a statutory underwriter.[17]

### III. Request for Comments

In addition to taking enforcement action against those who seek to evade the registration requirements of the Securities Act under the color of compliance with Regulation S,[18] the Commission is considering whether it is necessary to amend the regulation to deter these abuses and requests comment as to the need for revision of Regulation S. A number of proposed revisions have been suggested by commentators.[19] These suggestions are

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burden of establishing the availability of the exemption. *Securities & Exchange Commission v. Murphy*, 626 F.2d 633, 645 (9th Cir. 1980). Such exemptions are construed narrowly. *Id.* at 641.

[12] In addition, a purported Regulation S offering that involves a distribution in the United States may raise issues under Rule 10b–6 under the Securities Exchange Act of 1934. *See, e.g., R.A. Holman & Co., Inc. v. Securities & Exchange Commission*, 366 F.2d. 446, at 449, (2d Cir. 1966) (a distribution of securities is not deemed to be completed until the securities come to rest in the hands of the investing public).

[13] *See* Rule 144(d).

[14] Of course, some discounts may well be warranted in order to compensate for the length of the restricted period, historic volatility of the stock, financial condition of the issuer, the dilution represented by the newly issued shares, current market condition, availability of current information as to the issuer, information the issuer may have had that was disclosed to the purchaser but not otherwise disclosed to the market, or other factors. Nevertheless, some discounts have been so unrelated to the economics of the transaction that the only justification that can be ascertained is that they are part of a parking or holding scheme where the offshore purchaser is simply being used as a conduit for what is in reality an onshore financing.

[15] *See* Securities Act Release No. 7187, Part II.A, which addresses equity swaps and other like investment strategies in different contexts.

Securities would not be deemed to have come to rest abroad during the restricted period if the securities were pledged as collateral, either in a margin account or otherwise, where the expectation was that the collateralization would shift the benefits and burdens of ownership to the lender as opposed to the purchaser and the lender was not offshore.

[16] Since the market for the securities is in the United States, the short-selling or other hedging transaction occurs in the United States markets. If the short-selling or other hedging transaction occurred solely by or among parties offshore, and the purchaser engaged in the transaction could reasonably expect that the economic risk of ownership would remain abroad, then the transaction could satisfy the requirements of the rule if the other provisions of Regulation S were satisfied.

[17] Public resales in the United States by persons that would be deemed underwriters under Section 2(11) of the Securities Act [15 U.S.C. 77b(11)] would not be permissible without registration or an exemption from registration. Footnote 110 of the Adopting Release, which addresses the restricted periods, should not be read to provide otherwise.

Section 4(1) of the Securities Act [15 U.S.C. 77d(1)] exempts ''transactions by any person other than an issuer, underwriter, or dealer.'' Section 2(11) defines the term ''underwriter'' as:

Any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking. . . . As used in this paragraph the term ''issuer'' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

Accordingly, any distributions by a statutory ''underwriter'' must be registered pursuant to Section 5. *United States v. Wolfson*, 405 F.2d 779, 782 (2d Cir. 1968), cert. denied, 394 U.S. 946 (1969).

[18] *See*, for example, *United States v. Sung and Feher*, Litigation Release No. 14500 (May 15, 1995); *Securities and Exchange Commission v. Softpoint, Inc., et al.*, Litigation Release No. 14480 (April 27, 1995).

[19] *See* Ajhar, ''Foreign Stock Sales: Don't Get Blindsided,'' Worth p. 37 (March 1994); The Corporate Counsel, March-April 1995; E. Greene, ''Recent Problems Under Regulation S,'' Insights

being considered by the Commission and comment is requested on each of the proposals that follow. Commentators' proposals have generally focused on common stock placements by domestic issuers. Is there a comparable need for such restrictions in the case of foreign issuers' equity for which the United States is the sole or principal market, or for any other class of securities?

1. *Extend the Restricted Period.* Currently, the restricted period under the category 2 safe harbor [20] for offerings of securities of domestic companies that are reporting under the Securities Exchange Act of 1934 (the ''Exchange Act'') [21] is 40 days. Some have suggested extending the restricted period, for example, to one year in the case of equity securities of domestic issuers. One commentator has suggested that such offerings should be subject to the more restrictive conditions of the category 3 safe harbor,[22] which are currently generally applicable to offshore offerings by non-reporting domestic issuers. This would not only extend the restricted period to one year but also require legending of share certificates and an express agreement by the purchaser to resell the securities only in accordance with an available exemption from registration.

2. *Exclude certain discounted offers from the safe harbor.* Another possible revision would be to limit use of the category 2 safe harbor by domestic issuers offering common stock to those offerings sold at the market price or with a specified minimal discount. Those selling at a disqualifying discount could proceed under Rule 901 if the facts and circumstances established that the placement was truly an offshore offer and sale and not part of a plan or scheme to evade the registration requirements of the Securities Act. Alternatively, rather than exclude some or all discounted offerings from the issuer safe harbors, should instead a longer restricted period or all of the category 3 procedures apply to discounted offers?

3. *Restrict risk shifting transactions during the restricted period.* Should the safe harbor require selling restrictions that limit purchasers' ability during the restricted period to sell short or otherwise take a short position with respect to, or otherwise hedge the risk of holding common equity securities?

4. *Prohibit payment with certain types of non-recourse or other types of promissory notes where the expectation of repayment derives solely from the resale of securities.* Should the category 2 or 3 safe harbor be amended to prohibit (or limit through tolling of the restricted period) payment for common equity securities with certain types of non-recourse or other types of promissory notes where the expectation of repayment derives solely (or primarily) from the proceeds of resale of the securities?

## IV. The Role of Regulation S in Companies' Capital Raising Plans

The Commission, when it adopted Regulation S, understood and intended that legitimate offshore transactions whereby the issuer intended that its securities would be sold and placed offshore would be covered by Regulation S. Regulation S clarified and simplified procedures for offshore placement of securities and was intended to provide U.S. issuers with an efficient capital raising alternative. The Commission understands, in part due to its participation in the Government-Business Forum on Small Business Capital Formation, that there are issuers, particularly those ineligible to use shelf registration, that view offshore offerings as an important financing alternative. The Commission is soliciting comments as to the types of companies that are using Regulation S, how are they using it, and what mechanisms can be used to prevent abuse without unduly deterring legitimate offshore capital raising activities.

Reportedly, many small business issuers consider Regulation S offerings an important financing tool. Is this due to the increased pool of potential investors, or to the process involved in accomplishing a Regulation S offering versus a registered offering, or both? The Commission also recognizes that issuers may be compelled to sell securities offshore, rather than in registered transactions, because of registration disclosure requirements relating to significant acquisitions. As noted above, in a companion release, the Commission is addressing this concern through rule proposals to streamline these disclosure requirements. The Commission is seeking comments as to what other impediments in the current system may lead to problematic Regulation S offerings, and what commenters suggest should be done to alleviate these problems so that resorting to problematic Regulation S practices can be eliminated.[23]

Further, the Commission requests that commenters address the benefits and costs and other burdens to investors, issuers, and other market participants that would result from any of the suggested changes to Regulation S noted in Section III above.

## V. Cost-Benefit Analysis

The Commission requests views and data relating to the costs and benefits associated with the proposals relating to additional restrictions for offerings under Regulation S. It is expected that such restrictions would not directly impose additional burdens on companies, although there may be indirect costs incurred by companies.

## VI. Request for Comments

Any interested person wishing to submit written comments on any aspect of the amendments to forms and rules that are subject to this release are requested to do so. Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549 and should refer to file number S7–20–95.

## List of Subjects in 17 CFR Part 231

Securities.

## Amendment of the Code of Federal Regulations

For the reasons set out in the preamble, Title 17 Chapter II of the Code of Federal Regulations is amended as set forth below:

(August 1994); ''Rule Permitting Offshore Stock Sales Yields Deals that Spark SEC Concerns'', Wall Street Journal, at C1, April 26, 1994.

[20] Rule 903(c)(2).

[21] 15 U.S.C. 78a *et seq.*

[22] Rule 903(c)(3).

[23] The Commission has established the Advisory Committee on the Capital Formation and Regulatory Processes (the ''Advisory Committee''), chaired by Commissioner Steven M.H. Wallman. The Advisory Committee is considering fundamental issues relating to the regulatory framework governing the capital formation process, including whether the current system of registering securities offerings should be replaced with a company registration system. The recommendations of the Advisory Committee may result in rule proposals or legislative recommendations that, if endorsed by the Commission, ultimately may address the matters discussed in this release. Under some of the company registration models being considered by the Advisory Committee, the need to draw legal distinctions between securities issued by registered companies in public offerings conducted domestically and offshore would be significantly reduced. All securities issued by companies registered with the Commission would be freely tradable in this country, regardless of the public or private, or domestic or offshore, nature of that offering.

## PART 231—INTERPRETATIVE RELEASES RELATING TO THE SECURITIES ACT OF 1933 AND GENERAL RULES AND REGULATIONS THEREUNDER

Part 231 is amended by adding Release No. 33–7190 and the release date of June 27, 1995 to the list of interpretive releases.

Dated: June 27, 1995.

By the Commission.

**Margaret H. McFarland,**

*Deputy Secretary.*

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